No. 2813.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

JOHN A. ROEBLING'S SONS COMPANY OF CALIFORNIA and I. P. MORRIS COMPANY,

Appellants,

vs.

IDAHO RAILWAY LIGHT & POWER COMPANY, O. G. F. MARKHUS, Receiver of said Company, GUARANTY TRUST COMPANY, Trustee, ELECTRIC INVESTMENT COMPANY, AMERICAN STEEL AND WIRE COMPANY, GENERAL ELECTRIC COMPANY and WESTINGHOUSE ELECTRIC AND MANUFACTURING COMPANY,

Appellees.

PETITION FOR REHEARING.

BEVERLY L. HODGHEAD,

Attorney and Solicitor for John A. Roebling's Sons Company of California, a corporation, and I. P. Morris Company, a corporation.

The James H. Barry Co.
San Francisco

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT.

JOHN A. ROEBLING'S SONS COMPANY OF CALIFORNIA and I. P. MORRIS COMPANY,

Appellants,

vs.

IDAHO RAILWAY LIGHT & POWER COMPANY, O. G. F. MARKHUS, Receiver of said Company, GUARANTY TRUST COMPANY, Trustee, ELECTRIC INVESTMENT COMPANY, AMERICAN STEEL AND WIRE COMPANY, GENERAL ELECTRIC COMPANY and WESTINGHOUSE ELECTRIC AND MANUFACTURING COMPANY,

Appellees.

No. 2813.

PETITION FOR REHEARING.

To the Honorable Justices of the Circuit Court of Appeals of the United States, in and for the Ninth Circuit:

This case is of such vital consequence, not only to the parties concerned, but because it involves an important principle of law upon which the Honora-

ble Justices of this Court are divided in opinion, that appellants respectfully urge a rehearing.

In this petition, it is not our intention to reargue the entire appeal, but do request the Court to review one or two controlling features which we feel confident will convince the majority of the Court that this case is distinguishable from the rigid line of cases with which it is classified, yet which in fact involved no diversions of income; and especially we ask the Court's attention to the portion of the record showing the part which the bondholders themselves had in the transaction, and which should estop them from denying the equity of appellants' claims of preference.

We will not argue the claim that the so-called "six months rule" is not absolute. The opinion of the majority of the Court admits this point, that is, "that the six months rule is not inflexible" (*Crane* vs. *Fidelity Trust Co.,* 238 Fed., 693). As pointed out in the briefs of these appellants and in the dissenting opinion of Mr. Justice Gilbert in the *Crane case,* which was adopted by him as the basis of his dissent here, claims older than six months have been allowed so many times by the Supreme Court and by the Circuit Courts of Appeal, including the *Tacoma case* in this Circuit, that we take it that if the majority of the Court were convinced that the other defenses discussed in this case were not tenable, the appeal, owing to the special circumstances which we will

refer to, would not be denied because the claims accrued or were incurred more than six months before the appointment of the receiver.

The special circumstance which would incline the Court to depart from the so-called "six months rule" is the fact which we think can be made entirely clear, that the bondholder himself, and not the Railway Company, directed the purchase of this material from appellants, and that they sold it under the expectation and belief that it was to be paid for from the particular earnings which were diverted to the payment of interest on the bonds.

As stated by Mr. Justice Gilbert, in his dissenting opinion in the case of *Crane* vs. *Fidelity Trust Co.*, 238 Fed., 699:

> "An equitable right of so meritorious a nature should not, we think, be barred by an artificial rule of 6 months limitation, or by a lapse of time (within the statute of limitations) other than a delay which must result in prejudice to the mortgagee."

THE PART OF THE BONDHOLDER IN THE TRANSACTION.

The vital feature of these cases which we respectfully urge upon the Court and which was not discussed in the majority opinion is, that the material and supplies for which preference is claimed were in fact purchased from appellants by the agent of the bondholders themselves as managing director of the Railway Company, and that it was sold in the

belief and expectation that the material would be paid for from the very earnings which we are now seeking to have restored and applied, as was intended, for the payment of such material. Mr. Justice Hunt, in the majority opinion, says:

> "If there is an outstanding mortgage contract between the corporation and the mortgage creditor such as there was here, preference will not be awarded over the mortgage creditors, unless it is proven that all parties agreed that the claim of the merchant shall be first paid out of current earnings of the buying company."

The record in this case, we say confidently, meets this requirement, that is, the mortgage creditor himself directed the purchase of the material and allowed the appellants to believe that the earnings which were applied upon the bondholders' interest on June 1, 1913, would be used for the payment of these supplies, which, under the cases cited below, is sufficient for the purpose of such claims.

Let us inquire if these statements are borne out by the record. First, did the bondholder have anything to do with the purchase of the material? Both at the time the material was purchased and delivered, and at the time of the diversion of earnings complained of, Mr. Samuel L. Fuller, the manager of the bondholders' syndicate, was also the active man-

aging director of the Railway Company in respect to its finances. The record shows as follows:

> "Mr. Fuller was the head of the syndicate" (Testimony of O. G. F. Markhus, Receiver, Tr., p. 118).
>
> "That syndicate is managed by my firm, as syndicate managers" (Testimony of Samuel L. Fuller, Tr., p. 129).
>
> "Samuel L. Fuller is the vice-president of the Railway Company, and with respect to finances he was in fact its managing director" (Testimony of Receiver Markhus, Tr., p. 118).
>
> "The order (for material) was placed here. I don't recall who instructed me to give the order, *but we got instructions from New York*" (Testimony of Receiver Markhus, Tr., p. 118).

The order on June 1st to divert the earnings of the Railway Company, available for the payment of appellants' claims, to the payment of the interest on the bonds, must also have come from the management which owned the bonds. Stated more clearly, the manager of the bondholding syndicate, who was also the Vice-President and managing director of the Railway Company, himself was responsible for the purchase of the material, which was to be paid for out of the earnings, and almost immediately thereafter diverted the earnings to the payment of the interest on his own bonds.

The Stipulation of Facts recites that the appellants sold the supplies and material in the belief and

in the expectation on their part that the same should be paid for out of current operating income.

The Supreme Court decided in

> *Virginia & Alabama Coal Co.* vs. *Central R. R. Co.,* 170 U. S., 356,

that it was only necessary as to that matter for it to appear that "it was the expectation of the *creditors* that the indebtedness created would be paid out of the current earnings of the company." See page 368, where it is said:

> "The dominant feature of the doctrine, as applied in *Burnham* vs. *Bowen,* is that where expenditures have been made which were essentially necessary to enable the road to be operated as a continuing business, and *it was the expectation of the creditors that the indebtedness* created would be paid out of the current earnings of the company, a superior equity arises in favor of the materialman as against the mortgage bonds, *in the income* arising both before and after the appointment of a receiver from the operation of the property."

This language was quoted and approved in the *Carnegie case,* 176 U. S., at p. 285.

In *Moore* vs. *Donahoo,* 217 Fed., at p. 184, the Court reviewed this question and said:

> "So with the unsecured claimant: Such equity as he may have flows from the fact that, in the ordinary course of business, he has performed labor or furnished necessary supplies to the railroad company *with the expectation of being paid therefor from certain funds.*"

In the instance cited by Mr. Justice Hunt in the prevailing opinion, the mortgage creditor had no part in the transaction. Here the mortgage creditor directed the transaction, and we respectfully urge should be held to the terms thereof, instead of being permitted to retain the property and also the earnings intended for payment thereof.

If it can be shown that there was a diversion of earnings in this case to the payment of interest on the bonds, and that the earnings so diverted were the particular earnings which it was intended and expected should be applied in payment of these claims, and that this purchase was made at the instance of the bondholders themselves, the case certainly presents stronger equitable grounds for preference than the Kneeland and Thomas and Gregg cases referred to in the prevailing opinion in the Crane case, which involved no diversion of income and where the bondholders had no part in the transaction leading to the purchase of the material.

DIVERSION OF INCOME.

Was there any diversion of income for the payment of interest with respect either to the Roebling or Morris claims? Appellants contend that the earnings which were used to make up the interest payment on June 1, 1913, upon the bonds of the mortgage creditors, were the particular earnings or income which it was intended should be used in payment of these

claims, and it is inequitable to permit for the bondholder through its managing director, who at the same time was managing director of the Railway Company as to finances, to take these earnings and divert them to the payment of his own interest. It is agreed that the material purchased added to the value of the mortgage security, the full amount of the price paid therefor. It is shown by the record and it is stated in opinion of the Court in this case, that of the money used for the payment of interest on the bonds on June 1, 1913, "$79,000 was obtained from the earnings of the Company during the period mentioned." It is further stated in the opinion of the Court, which is supported by the record and Stipulation of Facts, that this interest reserve was being set up by the Company from the earnings *"during the time when the supplies were furnished,"* that is, as to the Roebling claim between the 18th day of March and the 30th day of May, 1913. The material was sold and was delivered from time to time between those dates, and it was intended, as shown by the Stipulation of Facts, that the sale was to be for cash, within thirty days, and it must therefore have been expected that it was to be paid from the earnings "during the time when the supplies were furnished." We, therefore, respectfully but earnestly take issue with the Court in the statement that "there was no diversion of any income earned *after the accrual* of the Roebling Sons Company's claim."

But even if this were true, we also contend that the preferential claimant is not limited to the income which has been earned after the claim *accrued,* but is entitled to look to the earnings after the debt was *incurred.* This Court so determined explicitly in the case of

Moore vs. *Donahoo,* 217 Fed., 186,

where it is said that otherwise "generally speaking, " it would inevitably result that claims most recently " accruing, and therefore most clearly entitled to pro- " tection, would least often be in a position to de- " mand a restoration of diverted funds." The full decision of the Court on this point is as follows:

> "The appellants insist upon the former standard; that is, that there can be no diversion as to any creditor until his claim becomes due. In that view, if we suppose that employes upon monthly salaries, payable upon the 10th day of each succeeding month, render services to a corporation during a given month in expectation that they will be paid out of the current income, which they help to create, and upon the 1st day of the following month such income is applied to the payment of claims for betterments, and thereupon the mortgagee commences a suit in foreclosure and procures the appointment of a receiver, it is clear that the employes are left remediless. Again, under such a rule, what relief is available for those who supply materials or perform labor during the month immediately preceding a receivership, in a case where the current revenues for that month are applied to the satis-

> faction of similar claims accruing during the preceding month, which have remained unpaid because of the diversion of the current revenues for that month to the discharge of interest on bonds? And, generally speaking, it would inevitably result that *claims most recently accruing,* and therefore most clearly entitled to protection, would least often be in a position to demand a restoration of diverted funds. It is doubtless true in actual practice that credit is extended for current supplies and for labor upon the assumption that there has been no improvident diversion of the current income in the immediate past quite as often as upon the expectation that there will be no such diversion in the immediate future."

The above rule applies similarly to the claim of appellant, the I. P. Morris Company. The debt in that case had not become due when the interest was paid on June 1st, but it has been *incurred* and the Railway Company had received the material. The earnings used for the payment of interest were derived *"during the time the material was being supplied,"* and after the debt was incurred. The current supply creditor therefore, under the rule of the cases above cited, was entitled to look to these earnings for the payment of its claim.

In the Morris case the material was delivered to the Railway "in the spring of 1913," and the first unit was installed and placed in operation about June 1st (Tr., p. 69).

THE CHARACTER OF THE MATERIAL.

We earnestly contend that in view of the extensive system of railway and electric properties operated by the defendant company, the material and supplies furnished under the circumstances above related, were properly chargeable to maintenance and operation, and that this claim is within the rule of the case of

> *Southern Railway* vs. *Carnegie Steel Co.,* 176 U. S., 258.

In the *Carnegie case* and the *Lackawanna case,* 176 U. S., p. 298, decided the same day by the Supreme Court, the character of the material was the same. In each case the material was for steel rails. The difference was in the quantity. In the *Lackawanna case* the claim of preference was *denied* on the ground that the quantity was so large that, relatively speaking, it amounted to reconstruction. In the *Carnegie case,* the claim was for the price of 2500 tons of steel rails and preference was *allowed* because "the quantity was not so large as to preclude the expectation that they could be paid for out of the current earnings of the railroad" (176 U. S., 290). The question is a relative one. The test seems to be, as stated in the *Carnegie case, whether it may reasonably be expected that payment is to be made from current earnings.* In this appeal, it is admitted in both Stipulations of Fact that it was the expectation

of the creditors that the indebteness be paid from the current earnings. It was reasonable for them to expect such payment because the record shows that the earnings were sufficient for that purpose, and the amount of the claim was insignificant when compared with the system of properties owned and operated by the Railway Company. The material was supplied to meet the actual needs of the corporation, and we think it but just, when comparing the amount of the material furnished, to consider the Railway Company's entire system instead of segregating it into separate parts which might make the quantity furnished, relatively considered, so large as to amount to construction instead of maintenance and operation. The admitted facts justify us in contending that the entire system of railway and electrical properties should be considered in connection with this claim instead of its component parts, because of the admission, at least in the *Morris case,* "that the machinery is necessary to the continued operation of the Railway Company's system" (Tr., p. 72), and further, that the properties of the Railway Company were an *indivisible system,* and the power and railway properties used in connection with each other (Tr., pages 99-100).

It is said by the Court in the prevailing opinion in the *Crane case* (238 Fed., 697) in referring to the case of *Miltonsberger* vs. *Logansport* and other cases, that they were decided fifteen years before the be-

ginning of the series of decisions found in the *Kneeland* and *Thomas cases* and others, but we respectfully draw the attention of the Court to the fact that later than the *Kneeland* and *Thomas cases* is the *Carnegie case,* 176 U. S., 257, and concerning those cases the Court said:

> "In neither the Kneeland nor the Thomas case *was there any intention to question the prior decisions of the Court,* which allowed priority to claims based upon the furnishing of essential and necessary current supplies, not sold upon mere personal credit, against the surplus income arising during the operation of the road under the direction of a court of equity."

The case which seems peculiarly analogous to the one under discussion, because it deals with the part which the bondholder had in the transaction, is the case of

Union Trust Co. vs. *Souther,* 107 U. S., 591.

The Court was dealing with the income after the appointment of a receiver, but we take it there is no essential difference in the rules defining material used for construction, and material and supplies used for maintenance and operation before and after the appointment of the receiver. The point in the case of *Union Trust Co.* vs. *Souther* was that material and supplies added to the value of the property, afterwards sold, and would have been chargeable to construction, but because of the fact that the expenditure

was made at the request of the bondholders, the Court held that the supply creditors were entitled to restoration of the funds. In this connection the Court said:

> "The income of the receivership, instead of being applied in accordance with the order to pay the debts for the supplies and labor, was used, *with the consent, and it may fairly be inferred, at the request of the bondholders,* to buy additional grounds, rolling stock, etc., and to make permanent improvements, thus adding to the value of the property; which was afterwards sold. There is nothing whatever to indicate that in thus using the income it was the intention of the Court to revoke the original order. It seems to have been found, in the administration of the cause, that by using the income to add to the value of the fixed property the interests of all parties would be promoted, and so the fund, which in equity belonged to the labor and supply creditors, was for the time being diverted from them and put into improvements and additions, the proceeds of which are now in court. It is not to be presumed that this diversion would have been authorized if the value of the property added to and improved was not to be correspondingly increased. *Clearly, therefore, on the face of the transaction, the fund in court represents in equity the income which belongs to the labor and supply creditors as well as the mortgage security, and there was no impropriety in appropriating it as far as necessary to pay the creditors specially provided for when the receiver was appointed. Such a practice, under proper circumstances, was approved in Fosdick* vs. *Schall, ubi supra, and seems to us eminently just."*

We respectfully urge that inasmuch as this material was sold for cash and in the expectation that it was to be paid for from the earnings and that the particular earnings which must have been intended for its payment were diverted to the payment of the interest on the bonds, and that the bondholder directed the transaction and also controlled the diversion and received the benefit of the interest and also of appellants' property, it is inequitable to deny this claim. Appellants therefore respectfully petition for a rehearing.

Respectfully submitted.

BEVERLY L. HODGHEAD,
Attorney and Solicitor for John A. Roebling's Sons Company of California, a corporation, and I. P. Morris Company, a corporation.

I hereby certify that the foregoing petition for rehearing is not filed for delay and in my opinion is well founded in point of law.

BEVERLY L. HODGHEAD,
Attorney and Solicitor for John A. Roebling's Sons Company of California, a corporation, and I. P. Morris Company, a corporation.